

August 7, 2001

State of Connecticut  
Office of the Attorney General  
55 Elm Street  
Hartford, Connecticut 06106

Dear Mr. Richard Blumenthal:

**Healthcare Valuation and Financial Advisory Services  
in Connection with the Proposed Sale of Sharon Hospital**

This report presents our conclusions with respect to our assistance to the Office of the Attorney General of the State of Connecticut (the “AG”) in connection with your review, under section 19a-486 of the Connecticut General Statutes (“486 Review”), of the proposed sale of Sharon Hospital (“the Hospital”), a charitable not-for-profit acute care hospital located in Sharon, Connecticut, to Essent Healthcare of Connecticut, Inc. (“Essent Connecticut”), a wholly-owned subsidiary of Essent Healthcare of Nashville, Tennessee (“Essent”).

In connection with the proposed transaction (the “Proposed Transaction”) between the Hospital and Essent, Jay Alix & Associates (“JA&A”) has been retained to advise the AG on:

- The Hospital’s financial advisor’s fairness opinion;
- The Hospital’s process in making the determination to sell the assets;
- The Hospital’s process in selecting a purchaser;
- The Hospital’s process in retaining a financial advisor;
- The Hospital’s negotiation of terms and conditions of the Proposed Transaction;
- Whether the Hospital disclosed any conflicts of interest;
- Whether the Fair Market Value of the Hospital’s assets have been manipulated to decrease their value

- Whether the financing of the Proposed Transaction will place the Hospital's assets at unreasonable risk;
- The reasonableness of any management contract contemplated under the Proposed Transaction;
- Whether the Hospital will receive Fair Market Value for its assets; and
- The Fair Market Value of the Hospital

<b>SOURCES OF INFORMATION</b>
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The following is a general summary of the primary documentation that has been provided to us with respect to the referenced matter. In performing our analysis, we relied upon financial and other information, including prospective financial information, obtained from Hospital management ("Management") and from Essent and from various public, financial, and industry sources. Our conclusion is dependent on such information being complete and accurate in all material respects. However, as is customary in the business valuation profession, the scope of our work will not enable us to accept responsibility for the accuracy and completeness of such provided information.

In addition, we relied in part upon testimony of Management and members of the Board of Trustees of Sharon Hospital ("the Board") in determining the procedures leading up to the negotiation of the Asset Purchase Agreement with Essent Connecticut.

For the purposes of this analysis, we have reviewed the following documentation:

- Asset Purchase Agreement between Essent Healthcare of Connecticut and Sharon Corporation et al. dated October 14, 2000;
- Merrill Lynch Fairness Opinion dated October 14, 2000 and accompanying Board presentation;

- Sharon Hospital, Inc. Notice and Application pursuant to Connecticut General Statutes 19a-486;
- Various minutes of the meetings of the Board of Trustees of Sharon Hospital and Sharon Corporation, including special meetings and Executive Committee meetings;
- Documents relating to the search for partnering consultants;
- The Sharon Hospital March 2000 Request for Proposal;
- Responses and summaries of the responses to the Request for Proposal;
- The Asset Acquisition Agreement between Sharon Health Care et al. and United Methodist Home of Sharon, Inc. dated March 1, 2001;
- Various Connecticut Attorney General and Office of Health Care Access interrogatories and responses;
- Audited financial statements of Sharon Hospital for the fiscal years ended September 30, 1994 through 2000;
- Interim financial statements of Sharon Hospital for the year-to-date periods ended May 31, 2000 and 2001;
- Audited special purpose combined financial statements of Sharon Corporation and the Sharon Hospital, Inc. for the fiscal years ended September 30, 1994 through 2000;
- Signed conflict forms; and
- Projections prepared by Essent and Management

This list is not intended to be all-inclusive, but covers many of the documents that were found to be particularly relevant during our analysis.

<b>PROCEDURES</b>
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During the course of our analysis we undertook the following procedures among others:

- Met with Management to discuss the Proposed Transaction, financial performance and the future outlook for the Hospital and other pertinent information;

- Toured the Hospital;
- Interviewed John R. Chandler, Jr., Chairman of the Board of the Hospital; Daniel M. Cain, member of the Board of Directors of the Hospital; Michael R. Gallacher, former Chief Executive Officer (“CEO”) of the Hospital; Robert J. Wright, Jr., Chief Financial Officer (“CFO”) of the Hospital; and Joan Phillips, interim CEO of the Hospital;
- Interviewed the Hospital’s financial advisor, Merrill Lynch;
- Interviewed Hudson Connery, CEO of Essent and Michael Browder, CFO of Essent;
- Reviewed the processes involved in:
  - Making the determination to sell the assets,
  - The selection of the purchaser;
  - Retaining a financial advisor to issue a fairness opinion; and
  - The negotiation of the terms and conditions of the Proposed Transaction.
- Analyzed the terms of the Proposed Transaction;
- Analyzed the financial aspects of the Proposed Transaction as it relates to the estimated Fair Market Value of the assets being sold;
- Reviewed Merrill Lynch Fairness Opinion and Board presentation;
- Reviewed the proposed financing of the Proposed Transaction and its impact on the leverage and overall risk of the Hospital and Essent;
- Analyzed the Hospital’s historical financial and operating data;
- Analyzed transactions that have occurred in the hospital industry;
- Reviewed and analyzed Management projections and further developed these projections;
- Determined an appropriate discount rate; and
- Prepared a discounted cash flow model.

<b>HISTORY OF SHARON HOSPITAL</b>
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Sharon Hospital is a charitable, Connecticut 501 (c) (3) not-for-profit acute care hospital. The hospital is licensed for 78 general hospital beds and 16 bassinets by the Connecticut Department of Health. The Hospital currently provides a broad array of services on both an inpatient and outpatient basis. Services provided by the Hospital include among others: 24 hour emergency room service, cardiopulmonary services, CT scan, imaging, laboratory, mammography, midwifery, nuclear medicine, occupational therapy, oncology and outpatient surgery and outreach services.

The Hospital is located in Sharon, Connecticut, a town of approximately 2,800 people located in Litchfield County in northwest Connecticut. Sharon draws patients from Connecticut, New York State and Massachusetts. The Connecticut primary and secondary service areas have a combined population in excess of 71,000 residents with this number expected to grow steadily to approximately 72,500 residents by 2005.

There are six hospitals within 35 miles of the Hospital: Charlotte Hungerford, in Torrington, Connecticut; New Milford Hospital in New Milford, Connecticut; Vassar Brothers Hospital in Poughkeepsie, New York; St. Francis Hospital in Poughkeepsie, New York; Northern Dutchess Hospital in Rhinebeck, New York; and Fairview Hospital in Great Barrington, Massachusetts. Sharon Hospital refers patients to tertiary facilities including: Hartford Hospital and St. Francis Hospital, Hartford, Connecticut; Albany Medical Center, Albany, New York; and Yale Medical Center, New Haven, Connecticut. As of March 2000, the Hospital had 71 physicians on its active medical staff, 59 of which were attending physicians with unlimited privileges.

Sharon Hospital has been losing money for the last five years. The Hospital lost \$2.4 million in 2000 on an operating basis following operating losses of \$4.9 million, \$4.5 million, \$0.7 million and \$1.4 million in 1999, 1998, 1997 and 1996, respectively. In addition, the Hospital had negative Earnings Before Interest, Taxes Depreciation and Amortization ("EBITDA") in 1999 and 1998. For the latest twelve months ended May 31, 2001, the Hospital had positive EBITDA of \$1.2 million but is expected to have positive EBITDA of only \$21,400 for the fiscal year ended September 30, 2001.

According to Board Member and health care investment banker Dan Cain, when he joined the Board of the Hospital in 1998 the Hospital was experiencing many difficulties including:

- Losing money;
- Lacking in management systems;
- Experiencing a declining census and utilization;
- Lack of adequate capital;
- Need for physical upgrade of the facilities;
- Need to update billing and collection technologies;
- Changing demographics;
- A fairly competitive environment; and
- Experiencing other problems common among rural hospitals<sup>1</sup>

<b>DETERMINATION TO SELL THE ASSETS</b>
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The decision to sell the assets of the Hospital was a long, multi-step process. The Hospital had been struggling financially for quite some time and the economics of the health care industry were changing and becoming more complex. The Hospital and its Board, recognizing the need for assistance, engaged the health care consulting firm of Nolan & Bober Associates (“N&B”) to assist Management in creating a strategic plan.<sup>2</sup>

N&B worked with the Hospital from July 1998 to January 1999.<sup>3</sup> As part of their work, N&B analyzed the financial and operating performance of the hospital as well as the surrounding market and competitive forces. N&B was tasked with projecting the operating and resulting financial performance of the Hospital through 2003. The projections they developed included significant operating losses and N&B recommended that the Hospital reduce operating

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1 Interview conducted July 3, 2001

2 Sharon Hospital, Inc. Notice and Application pursuant to Connecticut General Statutes 19a-486

3 Robert Wright, Jr. answer to June 6, 2001 AG interrogatory

costs in the near term and that, for long term viability, the Hospital should seek some form of partnership.<sup>4</sup>

According to notes of the July 16, 1999 Executive Committee of the Sharon Corporation, Dr. Alderman reported that the Strategic Long-Range Planning Committee had endorsed three main objectives: a) To aggressively pursue a partnership agreement, b) attempt to structure a partnership with the three Litchfield County hospitals and c) initiate immediate discussions between teams from each hospital, with Mr. Gallacher, Mr. Chandler and Mr. Cain to represent Sharon Hospital.

Representatives of the Hospital met with Charlotte Hungerford, New Milford and Vassar Brothers hospitals to discuss partnering options. These discussions ultimately led nowhere due to differences in mission and the potential partners own internal problems.<sup>5,6</sup> Discussions were also held with Albany Medical, Berkshire Health System and St. Francis Hospital in Poughkeepsie, NY. These talks also proved fruitless.<sup>7</sup>

At this stage in the partnering process, the Hospital realized that they needed a facilitator who was familiar with the partnering process. Approximately five firms were interviewed to determine who could help the Hospital with their search for a partner. The firms considered included Ernst & Young, Deloitte & Touche, Cambio Health Solutions, LLC ("Cambio"), Minz Levin, Cambridge Research Institute, Oberfest Associates and Arnwine Associates. Cambio was chosen based on their comprehensive package of services including turnaround and brokerage expertise. Cambio brought in a team of operational people and did an immediate fiscal assessment of the situation and made recommendations similar to those offered by N&B: the Hospital needed to raise capital and improve the bottom line.<sup>8,9,10</sup>

On February 26, 2000 the Board voted to proceed with the partnering process and Cambio assisted in putting together a broad Request for Proposal ("RFP")

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4 Robert Wright, Jr. answer to June 6, 2001 AG interrogatory

5 Interview with Dan Cain conducted July 3, 2001

6 Interview with Robert Wright, Jr. conducted June 26, 2001

7 Ibid

8 Ibid

9 Interview with Michael Gallacher conducted June 26, 2001

10 List of Consultants for Partnering (Bates#005002)

for the Hospital.<sup>11</sup> The RFP specified that the Board would “entertain proposed transactions of all types including a lease, joint venture, partnership, merger, outright sale, etc. with both tax-exempt and taxable parties.” In March 2000, the RFP was distributed to fifteen parties that spanned both for-profits and non-for-profits.<sup>12,13</sup> In addition, there were several other hospitals eliminated prior to the RFP being sent out.<sup>14</sup>

<b>SELECTION OF PURCHASER</b>
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The selection of Essent as the potential purchaser of the Hospital was a result of the process outlined above regarding the decision to sell the Hospital as well as an evaluation of the bids submitted in response to the RFP. As noted earlier, RFP’s were sent to at least fifteen potential bidders. Of those receiving RFP’s, ten parties entered into confidentiality agreements with the Hospital: Community Health Systems (“CHS”), Essent Healthcare, St. Francis of Hartford, CT, Charlotte Hungerford, New Milford, Province Healthcare, Doctors Community Healthcare, Kurron Shares of America, Health Quest Systems and Hartford Health Care Corporation.

Of the ten potential bidders that had requested confidential information, only three parties actual offered bids for the Hospital and its assets: Essent, CHS and Vassar Brothers Hospital. The three bidders gave presentations to the Board on May 12, 2000.<sup>15</sup> In addition, Hud Connery of Essent made a second presentation on June 10, 2000.<sup>16</sup>

Vassar Brothers, through its parent company Health Quest, proposed that it provide management services to the Hospital on a contract basis and that Health Quest would assume control of all the assets of the Hospital. There was no offer of money for the acquisition of the Hospital’s assets, nor was there a proposed infusion of capital. In addition, the offer contained a \$25 million “break-up” fee if the Hospital attempted to pull out of the

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11 Minutes of the Board of Trustees of Sharon Hospital, February 26, 2000

12 Sharon Corporation RFP, March 2000

13 Partnering Candidates as of April 5, 2000 (Bates #007469)

14 Immediately prior to the issuance of this report we received a list of hospitals eliminated from the pre-RFP list but have not received an explanation as to why they were eliminated.

15 Minutes of the Board of Trustees of Sharon Hospital, May 12, 2000

16 Minutes of a Special Meeting of the Board of Trustees of Sharon Corporation and Sharon Hospital, June 10, 2000



transaction.<sup>17,18</sup> The offer from Vassar Brothers was rejected nearly immediately as being inadequate.<sup>19</sup> In regards to the other two bidders, Hospital representatives and Cambio conducted additional due diligence. Hospital representatives visited the Essent owned hospital in Wentzville, Missouri and a CHS owned hospital in Florida. Additionally, several of Sharon's doctors spoke with peers that worked or were involved with CHS and Essent's facilities and systems. Furthermore, the law firm of Epstein Becker & Green provided publicly available research to the Board relating to CHS and Essent.<sup>20</sup>

CHS bid \$21.8 million plus \$1 million for doctor recruitment and \$5 million in future capital expenditures. Essent bid \$16.39 million plus: approximately \$2.5 million for working capital, a commitment to spend \$8 million on capital expenditures over five years and agreed to pay for capital expenditures made prior to the October 14, 2000 Asset Purchase Agreement. The CHS bid was slightly higher than Essent's bid in dollar terms. However, CHS's bid included the purchase of Sharon Health Care Center ("SHCC"), a nursing home owned by Sharon Corporation, whereas Essent's bid did not. At the time of the bids, a rough value of \$2-3 million was ascribed to SHCC.<sup>21,22,23,24</sup> In the spring of 2001, subsequent to the signing of the Asset Purchase Agreement, SHCC was sold to United Methodist Home of Sharon, Inc. for \$7 million.<sup>25</sup> Therefore, the Essent bid was greater than the CHS bid on a comparable basis.

According to their bids, both CHS and Essent were committed to physician recruitment, capital expenditures, and maintaining existing medical services. In addition, Essent proposed joining with St. Francis Hospital of Hartford, CT to provide tertiary services.

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17 Sharon Hospital, Inc. Notice and Application pursuant to Connecticut General Statutes 19a-486

18 Summary of RFP Response prepared by Cambio Health Solutions, LLC (Bates#008303-008304)

19 Cain, Gallacher and Wright interviews

20 Robert Wright, Jr. Answer to June 6, 2001 AG Interrogatory

21 CHS response to Sharon RFP dated April 7, 2000

22 Essent response to Sharon RFP dated May 3, 2000

23 Summary of RFP Response prepared by Cambio Health Solutions, LLC (Bates#008303-008304)

24 Asset Purchase Agreement between Essent Healthcare of Connecticut and Sharon Corporation et al., dated October 14, 2000

25 Asset Acquisition Agreement dated March 1, 2001

Essent's bid, in addition to being the highest bid when compared on a comparable basis with CHS, was chosen for several qualitative reasons. The Board felt that with Essent being a small and relatively new company, Essent would be able to focus on the Hospital more than CHS, a large hospital system management company. The Board felt that Thoma Cressey's investment in Essent added comfort and heightened credibility to the bid. Additionally, they felt that Essent was more committed to the transaction and would be more willing to go through the potentially lengthy regulatory approval process.<sup>26,27</sup>

<b>PROPOSED TRANSACTION</b>
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As stated in the Asset Purchase Agreement dated October 14, 2000 between Essent Healthcare of Connecticut and Sharon Corporation et. al., Essent, through its wholly-owned subsidiary Essent Connecticut, is seeking to acquire certain assets of the Hospital and will assume certain liabilities along with its purchase of the assets. Essent is proposing to pay \$16.39 million plus 1,000 shares of Essent's Class B Common Stock and an amount equal to the Adjusted Working Capital, which is defined as the Hospital's current assets less the current liabilities excluding assets and liabilities that are specifically excluded from this transaction. Essent has also agreed to fund at least \$8 million worth of capital expenditures within the first five years of the close of the Proposed Transaction and to pay for the \$472,300 in capital expenditures that the Hospital made between April 7 and October 14, 2000.<sup>28</sup>

Essent Connecticut is purchasing all assets and assuming all liabilities except for the following:

Assets

- Restricted and unrestricted cash and equivalents including any board-designated funds;
- All non-transferable licenses, permits, certifications and government approvals and any records which the Seller is required to retain;

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26 Interviews with Robert Wright, Jr., Michael Gallacher and Dan Cain

27 Bruce Janelli, M.D. answer to June 6, 2001 AG interrogatory

28 May 7, 2001 Capital Expenditure Agreement between Essent and Sharon et al.

- Intercompany assets;
- Consumable goods and supplies exhausted prior to closing;
- Corporate charter and related items;
- Notes receivable from third parties;
- Assets owned by Sharon Health Care Inc. used for the operation of the Nursing Home
- Real property at 82 Amenia Road
- West Sharon Corporation assets with the exception of Real Property;

Liabilities

- Indebtedness of the Seller;
- Liabilities relating to government or other third party payors incurred prior to the closing date;
- Any liability to the above parties arising from this Proposed Transaction;
- Federal, state or local taxes for periods prior to closing or relating to the Proposed Transaction; and
- Many more liabilities including inter-company liabilities and potential liabilities

The Asset Purchase Agreement provides for an escrow account (the "Escrow") to be funded with \$4.1 million of the purchase price. This Escrow is being established to pay costs related to: a) Cost Reports arising from periods ending on or prior to the Closing date; b) indemnifications claims; c) uncollectible accounts receivable that were included on the balance sheet at Closing; d) two liabilities not assumed by Essent (an advance payment from a fiscal intermediary and estimated payments due to the Connecticut Unemployment Compensation Fund) with an aggregate estimated cost of approximately \$1.8 million; e) any working capital adjustments to be paid to Essent. The Escrow has an initial term of eighteen months. However, if there exist pending claims relating to the above mentioned items, then Essent can

instruct the Escrow agent to retain the necessary funds in the Escrow until the claim is resolved.<sup>29,30,31</sup>

#### **SELECTION OF FINANCIAL ADVISOR**

The Board of Directors retained Merrill Lynch to provide a Fairness Opinion for the transaction. Cambio recommended several potential financial advisory firms. ML was selected based on their experience and their fees.<sup>32</sup> We have not received any disclosure relating to the search for a financial advisor to prepare a Fairness Opinion. However, it has been represented that several potential financial advisors were interviewed.

#### **MERRILL LYNCH FAIRNESS OPINION**

As part of the 486 Review, the Hospital was required to obtain a Fairness Opinion confirming that the proposed purchase price was fair to Sharon Corporation, Sharon Hospital and West Sharon Corporation from a financial point of view. The Board of Directors retained Merrill Lynch ("ML") who issued a letter dated October 14, 2000 confirming that the proposed purchase price was indeed fair from a financial point of view.

ML determined that the value of Sharon Corporation ranged from \$9.3 to \$10.4 million as of October 14, 2000. As part of our analysis, we reviewed the ML Fairness Opinion and its assumptions. In addition to our analysis, the projections employed by ML were reviewed by Robert Wright.<sup>33</sup> We also spoke with ML regarding the procedures they followed and assumptions they made leading up to the issuance of their opinion.

However, we have not reviewed, nor been provided with, Merrill Lynch's workpapers and, therefore, cannot reach a conclusion with respect to their Fairness Opinion.

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29 Asset Purchase Agreement between Essent Healthcare of Connecticut and Sharon Corporation et al., dated October 14, 2000

30 Sharon et al. Sale to Essent of Connecticut, Inc. Sources and Uses of Transaction Proceeds as of May 31, 2001

31 Interview with Hud Connery and Michael Browder conducted August 4, 2001

32 Interview with Dan Cain conducted July 3, 2001

33 Interview with Robert Wright, Jr. conducted June 26, 2001

**NEGOTIATION OF ASSET PURCHASE AGREEMENT**

Following initial contact with Essent in the mid-March, Essent made two presentations to the Board, on May 12 and June 10.<sup>34,35</sup> On June 24, 2000 the Board approved entering into a Letter of Intent (“LOI”) with Essent.<sup>36</sup> The LOI was executed on July 3, 2001.<sup>37</sup> Subsequent to this, a subcommittee to monitor the negotiations process was formed. The subcommittee included Peter Krulewitch, David Olsen, Donald Maryland and Ben Heller. Epstein, Becker and Green also advised the Board on the negotiations process.<sup>38</sup>

During the course of the negotiations, Essent agreed to several items including: the continuation of the Hospital’s indigent and charity care policies, to include this covenant in any subsequent sale of the Hospital after the close of the Proposed Transaction and to remove the material adverse change closing condition with respect to adverse financial changes to the Hospital and changes resulting from Essent’s proposed interim management of the Hospital.<sup>39,40</sup> Essent also agreed to purchase the nursing home facility, at the option of the successor foundation to Sharon Corporation (the “Foundation”), for \$1.4 million if the Foundation was unable to sell the facility within six months of the closing of the purchase of the Hospital.<sup>41</sup> Given the numerous points discussed and negotiated, it appears that the Hospital and its representatives did a reasonable job in negotiating the Asset Purchase Agreement.

**CONFLICT OF INTEREST DISCLOSURE**

While we have not interviewed all parties involved in the Proposed Transaction, nor investigated their past histories and dealings, we have examined the conflict of interest disclosure forms submitted to the Attorney General’s office as part of their 486 Review. Additionally, we have spoken

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34 Minutes of Meeting of the Board of Trustees of Sharon Hospital, May 12, 2000

35 Minutes of a Special Meeting of the Board of Trustees of Sharon Corporation and Sharon Hospital, June 10, 2000

36 Minutes of Meeting of the Board of Trustees of Sharon Corporation, June 24, 2000

37 June 30, 2000 letter from Essent to the Board of Directors of Sharon Corporation

38 Minutes of the Board of Trustees of Sharon Hospital, September 23, 2000

39 Discussion Points for Sharon Board of Trustees dated September 27, 2000

40 Asset Purchase Agreement between Essent Healthcare of Connecticut and Sharon Corporation et al. dated October 14, 2000

41 June 30, 2000 letter from Essent to the Board of Directors of Sharon Corporation

with John R. Chandler, Jr., Daniel M. Cain, Michael R. Gallacher, and Robert J. Wright, Jr. After reviewing the conflict forms and speaking to selected parties that were actively involved in the decision to approve the sale of the Hospital to Essent, it appears there were no conflicts of interest in determining to sell the Hospital's assets.

#### **MANIPULATION OF FAIR MARKET VALUE OF ASSETS**

In the course of our review of the Proposed Transaction we examined the operating and financial history of the Hospital, as well as its expected future performance. One item that we examined was a 25% amnesty discount on self-pay accounts receivable that was offered by the Hospital during the month of October 2000. While some concern has been expressed with regard to this discount, we have examined this issue and believe the decision to offer the discount was made to maximize cash flow and appears to be an appropriate business decision.<sup>42, 43</sup>

While Sharon Hospital is clearly experiencing some financial distress, after completing our financial and valuation analyses, it does not appear as if the Fair Market Value of the assets of the Hospital have been manipulated in such a way as to materially decrease their value. In fact, the retention of Cambio in an effort to increase the financial health of the Hospital suggests that the Hospital was trying to increase its value.

#### **FINANCING RISK**

Essent was formed in March 1999 with backing from Thoma Cressey, an established private equity firm. Thoma Cressey, through its Fund VI stands ready to commit at least \$50 million in equity capital to Essent. Since its founding, Essent has acquired one hospital in Wentzville, Missouri and is currently pursuing at least one additional acquisition in addition to the Proposed Transaction.

We interviewed Hudson Connery, CEO of Essent, telephonically on July 16, 2001. One of the areas we focused our attention on was the proposed capital structure for Essent Connecticut, the proposed parent entity for the Hospital

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42 Answer to Connecticut Attorney General Interrogatory No. 2 (Bates#003668)

43 Interview with Joan Philips conducted June 26, 2001

post-transaction. Mr. Connery indicated that the capital structure was not finalized and that its final structure would vary depending on the Hospital's current and near term operating results. Thoma Cressey has indicated to Essent that they are prepared to finance the deal with 100% equity capital, if necessary and optimal.

A recent memo dated August 3, 2001 from the Hospital to the AG clarifies the future capital of the Hospital post-transaction. Due to the Hospital's continuing and projected losses for fiscal year 2001, Essent feels that the Hospital will be strengthened by Essent using 100% equity financing for the purchase. The only debt financing anticipated for the purchase price would be to finance any working capital and this would simply be a draw on Essent's existing revolving line of credit.

The capital structure of the Hospital post-transaction will also determine the financing of the future capital expenditures that Essent has committed to fund.

These capital expenditures could take the form of equipment leases, or if the Proposed Transaction is 100% equity funded, it is expected that the Hospital will generate future free cash flow that could be used to fund the capital expenditures internally. In fact, in the August 3<sup>rd</sup> memo, Essent projects that it will finance half of the 2002-2004 capital expenditures with debt or capital lease financing and half with the Hospital's free cash flow.

Mr. Connery confirmed that the only deal currently on Essent's books is an accounts receivable financing arrangement. He also indicated that any prospective debt associated with the proposed transaction could possibly be carried up on Essent's books. While Essent continues to pursue additional hospital acquisitions, it does not anticipate needing to contribute significant capital to its existing hospital in Wentzville, Missouri.

Given these disclosures, it appears that the amount of leverage in the anticipated capital structure of the Hospital falls within that observed within the hospital industry and does not expose the Hospital to unreasonable financing risk

#### MANAGEMENT CONTRACTS

There were no management contracts disclosed in this matter as of the date of this report and it is our understanding that Essent will manage the facility with existing internal staff or will conduct a search for senior management candidates after the close of the Potential Transaction.

#### VALUATION OF SHARON HOSPITAL

##### Fair Market Value

Fair Market Value is defined as the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. For purposes of this engagement, we assumed that the Hospital's business would be ongoing.

##### Industry Outlook

The United States health care industry consists of several sectors that serve different areas of health care needs. With approximately 5,000 facilities nationwide and approximately \$350 billion in annual net revenues, acute-care hospitals comprise the largest sector of the industry.<sup>44</sup> Historically, the sector has shown yearly revenue increases of 4% to 6%. This has been largely driven by an aging population and continued technological advances.<sup>45</sup>

One of the more consistent themes in the hospital industry within recent years has been the purchase of struggling nonprofit hospitals by more financially stable hospital chains, whether by investor-owned or other tax-exempt entities. Approximately 85% of the industry's hospitals remain nonprofit entities, but consolidation continues. According to the American Hospital Association ("AHA") the total number of U.S. community hospitals dropped another 1.2% in 1999 to 4,956. Acquisition activity has increased substantially in 2001 and analysts see this trend continuing throughout the rest of the year.<sup>46</sup>

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44 American Hospital Association Hospital Statistics 2001 Edition

45 Standard & Poor's Healthcare: Facilities Industry Survey 6/21/01

46 Credit Suisse First Boston analyst report 6/26/01



In spite of the consolidation, there remains a significant overcapacity of beds in the U.S. hospital system. This coupled with low occupancy rates has materially impacted hospital operating margins.<sup>47</sup> “Financially speaking, the future looks difficult for hospitals. Profits are falling, expenses are up, and Medicare reimbursement is not keeping pace with costs...Meanwhile, an increase in government regulations – from fraud compliance to new patient information standards – is taxing hospitals’ administrative efforts to control costs.” The number of hospital closures increased in 1998 to 43, up from 37 the year before according to the Department of Health and Human Service’s Office of Inspector General.<sup>48</sup> Reasons for the closures were cited as Medicare and Medicaid reimbursement rate reductions, low occupancy, financial problems, outdated equipment and facilities, and higher levels of competition.

Hospital admission trends remained positive in 1999 with a 1.2% increase according to the AHA. This is reflective of increasing admissions from the baby-boomer population and the consolidation trend that has removed some of the excess bed capacity. Average length of stay of all hospitals continued to decrease in 1999 to 5.2 days and outpatient revenue as a percent of total gross patient revenue continued to grow above its 1998 levels.<sup>49</sup> Smaller and rural hospitals tend to have an even larger percentage of revenues dedicated to outpatient services.<sup>50</sup> In general, outpatient services gross revenues are about half of inpatient gross revenues across the U.S.<sup>51</sup>

Several factors affect the overall performance of the hospital industry including Federal regulation, location and size. 1997 saw the implementation of the Balanced Budget Act (“BBA”). The BBA was intended to curb the looming health care crisis of double-digit growth in Medicare and the approaching insolvency of the Medicare Trust Fund. Initially, the BBA was projected to lower Medicare spending by approximately \$115 billion over a five-year period. According to 1999 estimates by the Congressional Budget Office, the number will likely be twice that amount. The BBA undercut the financial stability of the hospital industry. Since its enactment, operating profit

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47 Standard & Poor’s Healthcare: Facilities Industry Survey 6/21/01

48 HCIA-Sachs and Deloitte & Touche “The Comparative Performance of U.S. Hospitals: The Sourcebook, 2001”

49 AHA Hospital Statistics 2001 Edition

50 HCIA-Sachs and Deloitte & Touche “The Comparative Performance of U.S. Hospitals: The Sourcebook, 2001”

51 AHA Hospital Statistics 2001 Edition

as a percentage of revenue across the industry fell from 3.95% to 1.92% to in 1999. This represents more than a 50% decrease in average operating margin. Total profit margins have also dropped over two percentage points in that period.<sup>52</sup> In 1999, in an attempt to protect the financial well being of providers, Congress created the Balance Budget Refinement Act (“BBRA”) of 1999. The BBRA only reversed a small portion of the changes enacted by the BBA. Further legislation was introduced in 2000 through the Medicare, Medicaid, and SCHIP Benefits Improvement and Protection Act (“BIPA”). This legislation is expected to bring approximately \$37 billion in additional government relief to the health care industry; \$11.5 billion of which is expected to go directly towards the hospital industry.<sup>53</sup>

Additional help appears to be on its way for rural hospitals. The Rural Health Care Improvement Act (RHCIA) of 2001 has been formally introduced to Congress. The RHCIA is intended to address the disparities between rural and urban hospitals by potentially increasing Medicare reimbursement for rural hospitals. Although the Act has not yet been passed and revisions are likely, the industry is encouraged by its strong bipartisan support.<sup>54</sup>

Location is another key factor affecting hospital performance. HCIA-Sachs notes that hospitals in the Mid-Atlantic and New England were the least profitable in the nation. The 1999 total profit margins in those regions were a mere .77% and 2.91%, respectively. On average, small, rural nonprofit hospitals in the Northeast U.S. experienced occupancy rates more than 10% lower than the national average. Rural hospitals do tend to treat a less complex mix of patients and accordingly, lower expenses have allowed rural hospitals to earn higher profits than urban counterparts on average. In 1999, urban hospitals had over 40% higher administrative costs per discharge than rural hospitals.<sup>55</sup> In spite of these advantages, Sharon Hospital has seen negative operating margins each year for the past five years.

The last important factor affecting hospital performance is size. Larger hospitals have historically treated a more complex range of patients with more expensive treatments. Small hospitals obtain a much higher percentage of

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52 HCIA-Sachs and Deloitte & Touche “The Comparative Performance of U.S. Hospitals: The Sourcebook, 2001”

53 Standard & Poor’s Healthcare: Facilities Industry Survey 6/21/01

54 Credit Suisse First Boston analyst report 6/26/01

55 HCIA-Sachs and Deloitte & Touche “The Comparative Performance of U.S. Hospitals: The Sourcebook, 2001”

revenue from outpatient business than large hospitals. Large hospitals have also been better at holding lengths of stay to a minimum. In the New England and Mid-Atlantic regions of the U.S., hospitals with 25-99 beds have occupancy rates around 41%, over one-third lower than hospitals with 250-399 beds at around 65%. Operating revenue per adjusted discharge was also significantly lower for small hospitals.<sup>56</sup> According to HCIA-Sachs, larger hospitals tend to have a considerably greater ability to service their debt.

Investor-owned hospitals are experiencing a strong operating environment in 2001. Medicare reimbursement rates and HMO rate hikes have improved and profit margins have increased due largely to higher occupancy levels, lighter debt levels, and strategic acquisitions and divestitures. However, the picture for tax-exempt hospitals is strikingly different. Nonprofit hospitals are experiencing numerous problems, including Medicaid reimbursement rate pressures, higher levels of uninsured patients, rising drug and medical technology prices, and higher medical cost inflation. "The sharp contrast between the for-profit and non-profit segments of the hospital industry is startling. Moreover, the lack of access to equity capital markets will continue to place tax-exempt facilities at a significant disadvantage to their investor-owned peers...there is no sign that this divide will be eliminated or narrowed in the foreseeable future."<sup>57</sup>

<b>VALUATION APPROACHES</b>
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In order to determine whether the Hospital will receive Fair Market Value for its assets, we applied two standard valuation methodologies: the Income Approach and the Market Transaction Approach.

**Income Approach**

The Income Approach indicates the Fair Market Value of a business or the assets of a business based on the value of the cash flows that the business or the assets can be expected to generate in the future. A variation of the Income Approach, the Discounted Cash Flow Method, is comprised of four steps: 1) Estimation of future cash flows for a certain discrete projection period; 2) Estimation of the present value of the cash flows using a rate of

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56 HCIA-Sachs and Deloitte & Touche "The Comparative Performance of U.S. Hospitals: The Sourcebook, 2001"

57 Standard & Poor's Healthcare: Facilities Industry Survey 6/21/01

return that considers the relative risk of achieving the cash flows and the time value of money; 3) Estimation of the residual value of cash flows subsequent to the discrete projection period; and 4) Combination of the present value of the residual cash flows with the discrete projection period cash flows. The cash flows in this case would include a determination of the income producing potential of the client base.

Management and Essent prepared projections for the remainder of 2001 as well as for the years 2002 through 2004. After reviewing Management's projections, we believe they are consistent with what a willing buyer would assume (and somewhat optimistic given past performance.) Therefore we incorporated them into our analysis.

#### Rate of Return

We estimated the appropriate rate of return on the Hospital's capital using the Capital Asset Pricing Model, a standard industry methodology. As part of this analysis, we incorporated a small risk premium to account for the risk associated with the Hospital being more troubled than typical. The appropriate rate of return for an investment in the capital of the Hospital is 15% as of the valuation date.

#### Essent and Management Projections

Essent and Management prepared several sets of projections including one officially submitted August 3, 2001 ("the Projections"). The Projections show an operating loss of \$2.73 million for fiscal year ended September 30, 2001. This corresponds with an operating loss of \$1.15 million through May 31, 2001 and operating losses of \$4.54 million, \$4.86 million and \$2.39 million in 1998, 1999 and 2000, respectively. Projections show significant improvement with an operating profit of \$524,000 in 2002 rising to operating profits of \$2.11 and \$2.69 million in 2003 and 2004, respectively.

The improving operating income is a result of increased revenue growth and profitability. Net patient revenue is estimated to increase 13.1% in 2001 with further projected growth rates of 1.8%, 4.6% and 6.8% in 2002, 2003 and 2004, respectively. Operating expenses, as a percentage of net patient revenue, decrease steadily from 115.2% in 2000 to 96.4% in 2004.

### Discounted Cash Flow Method

We used the Projections to develop our DCF model. Using the Projections as a base, we were able to determine the expected free cash flows of the Hospital through 2004. To calculate free cash flow, we started with net income and added back non-cash charges for depreciation and amortization while subtracting increase in working capital and capital expenditure. We also added back interest expense since we are determining the value of all the capital of the Hospital, including debt and equity capital. Capital expenditures for 2002-2004 were included in the Projections. Working capital was estimated to be 10% of the change in net patient revenues based on the Hospital's history and levels observed in the industry. Using the discount rate detailed above, we brought these future cash flows back to their present value equivalent.

The Residual value is an estimate of the present value of the Hospital's cash flows subsequent to the discrete projection period (2001-2004). A residual cash flow was calculated based on growing 2004 revenue by 3% with constant margins and normalized capital expenditures and depreciation and amortization. The sum of the present value of the discrete cash flows and the present value of the Residual yielded an estimate of the Fair Market Value of the Hospital's total capital.

The Discounted Cash Flow Method results in an estimate of the Fair Market Value of the Hospital's capital of \$12.6 million. Details of this analysis can be found in Exhibit I.

### Market Transaction Approach

The Market Transaction Approach indicates the Fair Market Value of a business or the assets of a business by comparing it to other similar companies recently purchased. Considerations such as time of sale are analyzed and evaluated. The applicable transactions would be individual hospital purchases rather than the purchase of hospital management companies.

Over the past several years, we observed numerous transactions involving hospitals. These transactions involved the purchase of both for-profit and not-for-profit hospitals. These hospitals were located across the country and included both urban and rural hospitals. In addition, the financial performance of each hospital varied from troubled to healthy. We reviewed both private

and public transactions, however the terms of many these transactions are confidential.

Investors typically value hospitals based on a Market Value of Invested Capital ("MVIC") to EBITDA multiple. Based on our experience we observe transactions that were priced at an EBITDA multiple ranging from 5 to 7 times EBITDA. Hospitals with strong growth prospects would tend to be valued at the high end of this range. Due to the Hospital's historical performance and expected future performance, we would expect the Hospital to command a multiple at the low end of the range. As such, we applied a 5 times EBITDA multiple to the Hospital's results to determine a value of the Hospital's capital.

These multiples were then applied to the Hospital's projected operating results to estimate a value of total capital. We applied the appropriate EBITDA multiple to the Hospital's projected fiscal year end 2002 and 2003 EBITDA to determine the value of the Hospital's capital at those future points. In order to determine the value of the Hospital's capital today, it was necessary to discount the values back to today using a 15% discount rate, which corresponds with the rate applied in our DCF model.

The Market Transaction approach results in a Fair Market Value of the Hospital ranging from \$7.3 million to \$13.2 million. Details of this analysis can be found in Exhibit II.

#### **Guideline Company Approach**

The Guideline Company Approach indicates the Fair Market Value of a business or the assets of a business by comparing it to similar publicly traded companies. In this case, we are valuing a single Hospital, whereas the publicly traded hospital companies own many hospitals. The public companies are geographically diversified, benefit from economies of scale, typically have stronger growth as a result of acquisitions, have higher profit margins and more experienced management. For these reasons, we do not feel that the Guideline Approach is appropriate in determining the Fair Market Value of the Hospital.

<b>VALUE CONCLUSION</b>
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Based on our analysis using standard industry techniques, we determined the Fair Market Value of the Hospital to be within the range of:

\$10 to \$13 million

<b>JA&amp;A OPINION</b>
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In analyzing the proposed transaction, we reviewed the process by which the Hospital determined to sell the assets, including the retention of selected advisors, and how they determined the final terms and price of the Proposed Transaction.

The process leading up to the Proposed Transaction had several components:

1) The determination to sell the assets, 2) an RFP process to potentially interested parties, 3) the selection of a purchaser, 4) the negotiation of the terms of the Proposed Transaction, and 5) the selection of a financial advisor to render a Fairness Opinion. JA&A also investigated whether: 6) there was disclosure of any conflicts of interest, 7) the reasonableness of any management contracts associated with the proposed transaction, 8) there was a manipulation of the assets of the Hospital such that they decreased in value, and 9) whether there was undue risk associated with the proposed financing of the Proposed Transaction. Finally, JA&A reviewed whether the Hospital was receiving Fair Market Value for its assets.

After interviewing many of the parties involved in the decision making process and reviewing the disclosed documents relating to the sale process, several things become evident. The decision to sell the assets of the Hospital seems reasonable given the Hospital's financial and operational problems, the bleak outlook for the future, the recommendations of several outside consultants and the minimal interest shown by other not-for-profit hospitals. The Hospital went through a bidding process with potentially interested parties that created an open market, which is significant in ensuring that Fair Market Value is received. The selection of purchaser also seems reasonable given the higher bid price and the comfort the Board had with Essent and their commitment to the deal. The negotiations of the terms covered a span of several months and items did change between the original bid and the Asset Purchase Agreement.

One item that seemed particularly important to the Hospital representatives, the right of first refusal, was successfully obtained during the negotiations.

Additionally there do not appear to be any conflicts of interest or a material manipulation of the assets of the Hospital. No contracts for the future management of the Hospital by an outside management company were disclosed as part of the 486 Review process, as such, we cannot opine on this item. Also, the proposed financing associated with the Proposed Transaction does not seem to place the Hospital's assets at undue risk given that the projected leverage is in line with that found in the industry.

JA&A's estimation of the value of the Hospital actually falls below the proposed purchase price. Though we could not opine on Merrill Lynch's Fairness Opinion due to a lack of disclosure, their valuation also supports the proposed purchase price. As such, the Hospital appears to be receiving Fair Market Value for its assets.

<b>LIMITING CONDITIONS</b>
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This letter is intended solely for the use of the AG for the purpose stated herein and may not be used, in whole or in part, for any other purpose without our written consent. Our report has been prepared in accordance with and is subject to the conditions as agreed to in our engagement letter. Due to timing issues related to document discovery, it may be necessary for JA&A to update its opinion if additional material information becomes available subsequent to the submission of this report.

Yours very truly,  
JAY ALIX & ASSOCIATES

R. Bruce Den Uyl  
Principal